

REPORT OF EXAMINATION
OF THE
THE PRINCETON EXCESS AND SURPLUS LINES INSURANCE COMPANY
AS OF
DECEMBER 31, 2005

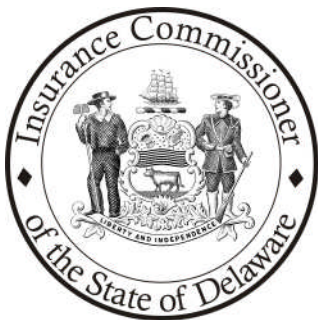
I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON EXAMINATION, made as of DECEMBER 31, 2005 of the

**PRINCETON EXCESS AND SURPLUS LINES
INSURANCE COMPANY**

is a true and correct copy of the document filed with this Department.

ATTEST BY: *Annette Handy*

DATE: 25 JUNE 2007



*In Witness Whereof, I HAVE HEREUNTO SET MY HAND
AND AFFIXED THE OFFICIAL SEAL OF THIS
DEPARTMENT AT THE CITY OF DOVER, THIS
25TH DAY OF JUNE 2007.*

Matthew Denn
Insurance Commissioner

REPORT ON EXAMINATION
OF THE
PRINCETON EXCESS AND SURPLUS LINES INSURANCE COMPANY
AS OF
December 31, 2005

The above captioned Report was completed by examiners of the Delaware Insurance Department.

Consideration has duly been given to the comments, conclusions, and recommendations of the examiners regarding the status of the Company as reflected in the Report.

This Report is hereby accepted, adopted, and filed as an official record of this Department.

A handwritten signature in black ink, appearing to read "Matthew Denn", written over a horizontal line.

MATTHEW DENN
INSURANCE COMMISSIONER

DATED this 25TH Day of JUNE 2007.

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SALUTATION

June 26, 2007

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Chairman, Financial Condition (E)
Committee, NAIC
State Corporation Commission
Bureau of Insurance
PO Box 1157
Richmond, VA 23218

Honorable Thomas E. Hampton
Secretary, Northeastern Zone (I), NAIC
Department of Insurance, Securities and
Banking
Government of the District of Columbia
810 First Street N.E., Suite 701
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Honorable Julie Mix McPeak
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Honorable Merle D. Scheiber
Secretary, Midwestern Zone (III), NAIC
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445 East Capital Avenue
Pierre, SD 57501-3185

Honorable Kent Michie
Secretary, Western Zone (IV), NAIC
Utah Department of Insurance
3110 State Office Building
Salt Lake City, Utah 84114-1201

Honorable Matthew P. Denn
Delaware Department of Insurance
841 Silver Lake Boulevard
Dover, Delaware 19904

Commissioners:

In compliance with instructions and pursuant to statutory provisions contained in Certificate of Authority No. 06.005, dated January 26, 2006, an Association examination has been made of the affairs, financial condition and management of the

THE PRINCETON EXCESS AND SURPLUS LINES INSURANCE COMPANY

hereinafter referred to as "Company" or "PESLIC" and incorporated under the laws of the State of Delaware as a stock company with its home office located at 2711 Centerville Road, Suite 400 Wilmington, Delaware 19808. The examination was conducted at the main administrative office of the Company located at 555 College Road East, Princeton, New Jersey 08543.

The report of such examination is submitted herewith.

SCOPE OF EXAMINATION

The last examination was conducted as of December 31, 2002. This examination covers the period since that date through December 31, 2005, and consisted of a general review of the Company's business policies and practices, management, any corporate matters incident thereto, a verification and evaluation of assets and determination of liabilities. Transactions subsequent to the latter date were reviewed where deemed necessary.

The format of this report is designed to explain the procedures employed on examination and the text will explain changes wherever made. If necessary, comments and recommendations have been made in those areas in need of correction or improvement. In such cases, these matters were thoroughly discussed with responsible officials during the course of the examination.

The general procedures of the examination followed the rules established by the Committee on Financial Condition Examiners Handbook of the National Association of Insurance Commissioners ("NAIC") and generally accepted statutory insurance examination standards consistent with the Insurance Laws and Regulations of the State of Delaware. In accordance with the aforementioned Handbook, the consulting firm of INS Services, Inc performed an information systems review.

This examination ran concurrently with the examinations of two Delaware domestic affiliated insurers, Munich Reinsurance America, Inc. ("MRAm"), formerly known as American Re-Insurance Company (name changed on September 5, 2006) and American Alternative Insurance Corporation ("AAIC").

In addition to items hereinafter incorporated as a part of the written report, the following areas were checked and made part of the files of this examination.

Fidelity Bonds and Other Insurance
Statutory Deposits
Employees' Welfare
All Asset and Liability Items not mentioned

HISTORY

The Company was incorporated on June 14, 1995 under the name of "The Princeton Excess and Surplus Lines Insurance Company" and commenced writing business on January 2, 1997. The current Company name was adopted on December 19, 1995.

On August 13, 1996, American Re Corporation (name changed on September 5, 2006 to Munich Re America Corporation "MRAC"), the Company's immediate parent entered into an Agreement and Plan of Merger with Munchener Ruckversicherungs-Gesellschaft Aktiengesellschaft ("Munich Re Germany" or "MRG," a Company organized under the laws of Germany) and Puma Acquisition Corporation, a Delaware corporation and a wholly owned subsidiary of MRG. Pursuant to the terms of the merger agreement, on November 25, 1996, following approval of the merger by MRAC's stockholders and applicable regulatory authorities, Puma Acquisition Corporation was merged with MRAC with the latter being the surviving company.

During July 1997, MRAC and MRG completed the merger of Munich American Reinsurance Company ("MARC"), the U. S. operations of MRG. At that time, the insurance assets and liabilities of the U.S. branch of MRG were merged into MRA, an affiliate of PESLIC. After the merger, MRG's ownership of MRAC stood at 91%. The remaining outstanding shares in MRAC were acquired from Victoria Versicherung AG in 1998 and from Allianz Aktiengesellschaft in 1999, bringing MRG's ownership interest in MRAC to 100%.

Munich-American Holding Corporation (“MAHC”), a Delaware Holding Company, was organized in September 2000. After regulatory approval, MRG contributed all of the issued and outstanding stock of MRAC, and therefore its subsidiaries, to MAHC.

No changes occurred during the current examination period.

CAPITALIZATION

Common Capital Stock

As of December 31, 2005, the Company had issued 10,000 shares of \$500 par value common capital stock amounting to \$5,000,000. All of these shares were issued to MRAC.

Dividends

PESLIC paid \$6,500,000 in dividends to MRAC in 2003.

Surplus Paid In

The Company received \$9,800,000 in surplus paid in from MRAC in 2003.

Surplus Note

On October 1, 2000, the Company issued a \$20,100,000 Promissory Capital Note to MRA at a 5% annual interest rate. The Note was approved by the Delaware Insurance Department.

All or any part of the principal or interest due pursuant to this Note may be repaid at any time, or from time to time, without penalty, but subject to the prior written approval of the Delaware Insurance Commissioner. In accordance with the 5% annual interest rate, the Company paid MRA \$1,005,000 in interest during 2005. The interest payment was approved by the Delaware Insurance Department.

MANAGEMENT AND CONTROL

Stockholders

In accordance with Article II, Section II of the Company's bylaws, the annual meeting of the stockholders shall be held each year on a date and at a time designated by the Board of Directors. At each annual meeting, directors shall be elected and any other proper business may be transacted. A majority of the stock issued and outstanding and entitled to vote at any meeting of stockholders, in person or represented by proxy, shall constitute a quorum. As previously noted, the Company has only one stockholder.

Board of Directors

In accordance with Article III, Section I of the Company's bylaws, the Board of Directors shall consist of not less than three and not more than eleven members. The number of directors shall be fixed or changed from time to time, within the minimum and maximum, by the vote of the stockholders or by the then appointed directors. A majority of the members shall constitute a quorum for the transaction of business at any meeting of the Board of Directors. The directors are elected at the annual meeting of the stockholder and each director serves until the next annual election and until their successors are elected and qualified.

At December 31, 2005, the members of the Board of Directors, together with their principal business affiliation, were as follows:

Name

Principal Business Affiliation

Albert J. Beer (1)

Chairman, Executive Vice President
Munich Reinsurance America, Inc.

Wolfgang R. Engshuber

Executive Vice President
Munich Reinsurance America, Inc.

John P. Phelan

President and CEO
Munich Reinsurance America, Inc.

(1) Albert J. Beer resigned as a director of the Company effective September 1, 2006. Subsequently, Murray Steven Levy and Robin Harriet Willcox, both officers of the Company at December 31, 2005, were elected as members of the Board of Directors.

Committees

The examiners noted the existence of a committee called the Risk Management Committee (RMC). The RMC has significant influence in the underwriting direction of MRAm. The RMC is responsible for determining underwriting authorities and limits. The examination noted that the Board of Directors in accordance with Article III, Section 3 of the bylaws had not appointed this committee, which is made up of members and non-members of the Board of Directors. This concern was presented to the Company during the course of the examination. Subsequently, the Company resolved this concern by officially chartering the RMC as a committee of the Board that reports directly to the Board.

Officers

The Company's bylaws state that Board of Directors is to appoint or elect the officers of the Corporation.

At December 31, 2005, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Albert J. Beer (1)	Chairman, President and Chief Executive Officer
Jeffery W. Davis (2)	Senior VP and Chief Actuary
Murray Steven Levy	Senior Vice President and Chief Financial Officer
John W. Rodgers	Senior VP and Chief Claims Officer
Robin Harriet Willcox	Senior VP, General Counsel and Secretary
Bonnie Boccitto	Senior VP
Anthony J. Kuczinski	Senior VP
Douglas E. Boyce	Senior VP

(1) Albert J. Beer resigned as Chairman, President and Chief Executive Officer effective September 1, 2006. Mr. Beer was replaced by Anthony J. Kuczinski, formerly a Senior VP of PESLIC.

(2) Mr. Davis is no longer with the Company.

Conflicts of Interest

The Company maintains a formal written conflict of interest policy, which officers, directors, and all key employees of PESLIC must fill out on an annual basis. The Policy Statement on Conflicts of Interest requires the disclosure of possible conflicts of interest on the part of officers, directors and employees whose positions are such that they exercise judgments or make decisions which may be influenced so as to result in a conflict of interest. Our review of the conflict of interest questionnaires completed during the examination disclosed no conflicts of interest that appeared to adversely affect the Company.

Bylaws

A review of the Company's bylaws revealed that no changes were made during the examination period.

Corporate Records

The Company's corporate records were reviewed for the period under examination. No exceptions were noted in addition to the recommendations previously disclosed in this Report of Examination.

HOLDING COMPANY SYSTEM

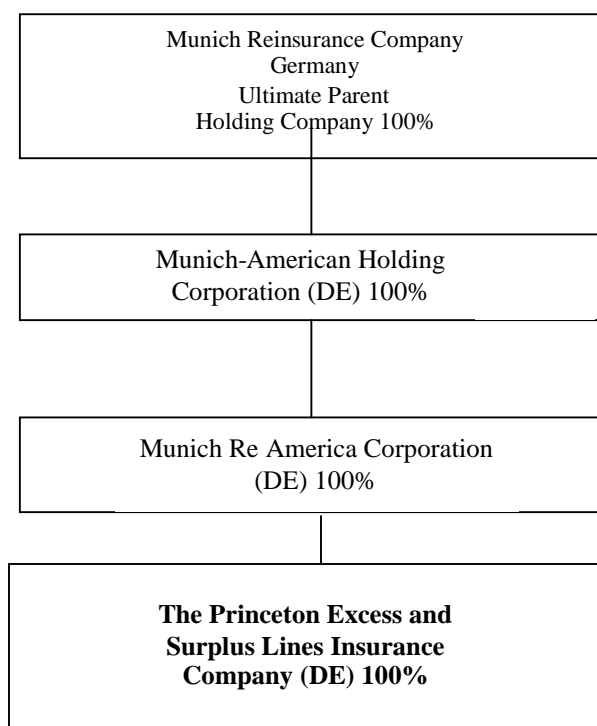
The Company is a member of an Insurance Holding Company System as defined under Chapter 50 of the Delaware Insurance Code. The Holding Company filings have been made pursuant to the Insurance Company, Holding Company System Registration provisions of 18

Del.C. §5004. The immediate parent of the Company at December 31, 2005 was MRAC and PESLIC's ultimate parent is MRG. MRG reported the following financial results as of December 31, 2005. The amounts below, which are in US dollars, were converted from the Euro at the December 31, 2005 conversion rate of 1.259 (rounded):

Assets	\$275,000,000,000
Equity	31,000,000,000
Net premiums written (2005)	45,600,000,000
Gain from operations (2005 pre-tax)	5,200,000,000

The following presentation of the holding company system, as of December 31, 2005, reflects only the identities and interrelationships between the Company and its direct parent, its intermediate parent, and its ultimate parent.

Organizational Chart as of December 31, 2005



A review of the annual *Form B* and *Form C* filings made by PESLIC for all years under examination revealed that the Company had complied with the requirements of Regulation 13 of the Delaware Insurance Code.

GROWTH OF THE COMPANY

The following information was extracted from copies of the Company's filed Annual Statements with the Delaware Insurance Department for each year indicated.

<u>Year</u>	<u>Net Admitted Assets</u>	<u>Surplus as Regards Policyholders</u>	<u>Gross Premiums Written</u>	<u>Net Premiums Written</u>	<u>Net Income</u>
2005	\$133,971,554	\$ 50,096,570	\$ 129,877,248	\$ 7,339,685	\$ 4,721,831
2004	125,199,721	46,085,684	126,682,191	13,467,187	5,927,365
2003	56,870,359	39,661,523	28,578,822	2,629,376	5,653,581
2002	39,153,805	30,577,002	18,780,468	1,784,675	4,001,237

The significant increase in assets from 2003 to 2004 was due to positive cash flow from operations, which was mainly caused by the significant increase in gross premiums written during the same period. The significant increase in gross premiums written was caused by the acquisition of new business and increased rates on renewal business.

Surplus as Regards Policyholders' increased \$19,519,568 or 63.8% during the examination period, caused primarily by net income of \$16,302,777 during the examination period along with \$3,300,000 of surplus paid in, net of dividends paid.

Following is a reconciliation of capital and surplus for the period under examination:

Policyholders' Surplus, December 31, 2002	\$30,577,002
Net income	16,302,777
Net unrealized capital gains or (losses)	64,495
Change in net deferred income tax	790,152
Change in non-admitted assets	(937,856)
Surplus paid in	9,800,000
Dividends to Stockholders	<u>(6,500,000)</u>
Policyholders' Surplus, December 31, 2005	<u>\$50,096,570</u>

TERRITORY AND PLAN OF OPERATION

Territory

The Company is licensed in the State of Delaware only and received its certificate of authority on January 2, 1997, to transact business as a multi line property and casualty insurance company. PESLIC began its underwriting operations in 1999 and continues its process of becoming an "eligible carrier" in all states to conduct business as a recognized excess and surplus lines carrier. In 2005, PESLIC reported direct premiums written in the District of Columbia and all states except California, Delaware, Minnesota, Utah and Wyoming.

Business is produced via retail and wholesale surplus lines brokerage firms, licensed as appropriate, who typically are retained by and represent insureds and risk managers of large Fortune 500 companies, municipalities, pools, associations and other similar entities.

The Company provides primary and excess specialty coverage as well as other difficult to place risks to its clients in states other than its domiciliary State of Delaware. Targeted insured clients are predominately large commercial enterprises, public entity pools, self-insured funds and other similar entities with generally high hazard exposures. For these, the Company plans to provide general and excess liability, umbrella, auto liability and physical damage and property coverage. The Company offers insurance coverage on a first dollar basis or with deductibles. Depending on the size of the deductibles, this can result in direct excess of loss policies.

During 2005 the largest lines of business written by the Company on a direct basis were as follows (including the percentage of total direct premiums written):

Other Liability - Occurrence	\$ 38,500,857	(29.6%)
Commercial Multiple Peril	\$ 35,857,261	(27.6%)
Other Liability - Claims Made	\$ 17,613,705	(13.6%)
Commercial Auto Liability	\$ 10,270,254	(7.9%)
Medical Malpractice - Claims Made	\$ 10,043,150	(7.7%)

These five lines of business accounted for 86.4% of total direct premiums written during 2005. Total direct premiums written during 2005 amounted to \$129,877,248. The Company utilizes several Third-Party Administrators (TPA's) for the solicitation and acquisition of business; however, none of these entities meet the definition of an MGA (Managing General Agent) as defined in 18 Del.C. §1802(3). Specifically, none of the TPA's is permitted to adjust or pay claims or to negotiate reinsurance on behalf of the Company.

Plan of Operation

During 2002 the US operations of MRG (MRG-US*) underwent a corporate restructuring. Separate Strategic Business Units (SBU's) were created for the purpose of segregating its major underwriting operations. The five main SBU's are Direct Treaty, Direct Facultative, Direct Broker, Risk Partners and Healthcare. The business underwritten by PESLIC is primarily produced by the Risk Partners SBU.

* = MRG-US consists of PESLIC, MRA and AAIC- the U. S. based insurance affiliates of MRG.

The corporate philosophy is that risks underwritten by MRG-US should have risk adequate premium, meaning that the appropriate premium for a given risk does not fluctuate simply because the reinsurance market is hard or soft. The Company appears to have applied

this underwriting discipline over the past few years. MRG-US is willing to restrain its underwriting when the market becomes soft and in the event that premiums are significantly lower than what the Company has determined are adequate for the risks being underwritten.

MRG-US has appointed a Chief Risk Officer and heightened its awareness of risks assumed as a whole. With regards to underwriting risk management, the Company has centralized the direction of underwriting guidelines. The Chief Risk Officer is closely aligned with the Integrated Risk Management Division of MRG in Germany. MRG-US intends to continue to integrate itself into MRG's operations. The companies that make up MRG-US continue to operate as separate legal entities, all domiciled in the State of Delaware.

The Company's underwriting goals and limitations are developed, reviewed and approved at MRG-US but are subsequently reviewed by MRG. MRG has an international or group wide business plan of which MRG-US is a significant part.

A.M. Best Rating:

Based on A.M. Best's current opinion of the consolidated financial condition and operating performance of the Company, PESLIC was assigned an A.M. Best rating of A (Excellent) for the year ending 2005. Subsequent to the examination date, this rating was reaffirmed in December 2006. A.M. Best notes that the rating reflects the Company's solid returns and substantial improvement in risk adjusted capitalization. Further, A.M. Best noted that PESLIC continues to make progress with regards to improvements in its operational and risk management controls.

REINSURANCE

For 2005, PESLIC reported the following distribution of premiums:

Direct	\$129,877,248
Assumed	0
Ceded to affiliates	(108,287,860)
Ceded to non-affiliates	(<u>14,249,703</u>)
Total Net Premiums Written	<u>\$ 7,339,685</u>

All of PESLIC's business, net of the specific cessions noted below, is ceded to an affiliate of the Company, Munich Reinsurance America (MRA), under the following reinsurance program:

For property-casualty business:

Excess of Loss	\$40 million of coverage excess of a retention of \$10 million per loss.
Quota Share	90% of most lines of business
Accident Year Stop Loss	100% cession in excess of an 102% loss ratio.

The ceded program with MRA basically remained unchanged during the examination period, except that two lines or classes of business were "carved out" and ceded on a 100% basis to MRA. The lines/classes of business were: Engineering and all business produced by the Global Risk Division of the Munich American Risk Partners Strategic Business Unit. In addition, an excess of loss treaty covering Umbrella and Excess Liability programs was cancelled in 2004. Finally, the ceded commission allowed PESIC under the MRA coverage was reduced from 30% to a combination of two amounts totaling 22.5%.

Total premium ceded by PESLIC to MRA in 2005 was \$107,448,000. Because MRA has provided the corporate ceded reinsurance program to PESLIC for many examination periods, the

loss recoveries are significant. At December 31, 2005, PESLIC reported total paid and unpaid reinsurance recoveries from MRA of \$212,104,000.

As noted above, premiums ceded to non-affiliates totaled \$14,250,000 in 2005. Interviews with management indicated that two large amounts are the key cessions to non-affiliates, and both involve situations where the reinsurer has a relationship with the agent producing the business for PESLIC. In 2005, PESLIC ceded premiums of \$8,781,000 to Hannover Rueckversicherungs AG for a portion of the reinsurance covering two programs produced for PESLIC by Arthur J. Gallagher Ltd. Also in 2005, PESLIC ceded premiums of \$5,469,000 to Senior Citizens Mutual Insurance Company, providing coverage on policies produced for PESLIC by Senior Citizens Risk Solutions.

INTERCOMPANY AGREEMENTS

The Company had the following significant intercompany agreements and arrangements in effect as of December 31, 2005:

Consolidated Income Tax Allocation Agreement

The Company is a participant in a consolidated federal income tax return with Munich-American Holding Corporation and all of its subsidiaries including two Delaware domestic insurance affiliates, MRA and AAIC. This arrangement is based upon a written tax allocation agreement dated December 31, 2005. This agreement amended and restated the previous agreement effective December 31, 2000. The agreement was approved by the Delaware Insurance Department.

Under this agreement, income tax expenses are computed on a separate company basis as if each affiliate was filing a separate tax return. Intercompany balances are settled on a quarterly basis. The terms of this agreement appear to be fair and equitable.

General Service and Administrative Agreements

On April 1, 2004, the Company restated its administrative services agreement with MRA for the performance of such management services as corporate finance, investment strategy, communications, public relations policies, actuarial, audit, executive, legal, personnel, benefits and benefit plans, accounting, tax and other financial services. Costs and expenses are allocated and payable each quarter. The agreement was approved by the Delaware Insurance Department and was not amended since the effective date. The terms of this agreement appear to be fair and equitable.

Investment Management Agreement

The Company is a party to an Investment Management Agreement with MEAG New York Corporation (MEAG-NY), an affiliated company. The agreement, which was effective August 1, 2001 and most recently amended on March 12, 2003, was approved by the Delaware Insurance Department. The agreement provides that MEAG-NY is to manage the investment and reinvestment of the Company's invested assets held by State Street Bank, the Company's most significant custodian.

MEAG-NY is required to adhere to strict investment guidelines, which are attached to the agreement and amended periodically whenever the Company amends its investment policy. The Company retains the sole authority to modify the investment guidelines. MEAG-NY is not permitted to trade assets that are designated by the Company as regulatory or trust deposits.

MEAG-NY does not act as custodian and does not physically hold any of the Company's invested assets. Regular reviews of the performance and actions of MEAG-NY are performed and the terms of the agreement appear to be fair and equitable.

EXTERNAL AGREEMENTS

In addition to the above intercompany agreements, the Company had the following significant external agreements in effect at December 31, 2005:

Custodial Agreements

The Company has entered into a custodial agreement with State Street Bank. The purpose of this agreement is for the safekeeping of the Company's invested assets. The NAIC's indemnification clause has been included in the agreement. The indemnification clause states that the custodian is obligated to indemnify the insurance company for any loss of securities of the insurance company in the bank or trust company's custody occasioned by the negligence or dishonesty of the bank or trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction. In the event that there is a loss of the securities for which the bank or trust company is obligated to indemnify the insurance company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be replaced.

Investment Accounting Services Agreement

The Company entered into an Investment Accounting Services Agreement (IASA) effective June 1, 2000 with BlackRock Financial Management, Inc. (BlackRock). Per the IASA, BlackRock performs PESLIC's investment accounting transaction entry along with asset reconciliations, income and dividend projections, foreign exchange calculations and review of all investment results. Further, BlackRock performs the monthly closing process and provides PESLIC with a transaction journal and transaction ledger along with a Client Holding Report showing PESLIC's investment portfolio sorted by CUSIP number and by investment

classification. The Client Holding Report contains most investment information necessary for the Company to complete its financial statements.

BlackRock provides PESLIC with a SAS 70 Report annually and PESLIC has the right to audit the BlackRock operations. The terms of the agreement appear to be fair and equitable.

LEGAL ACTIONS

The Company is a party to various litigation and claims, common to its business. Management believes that the outcome of such matters will not have a material adverse impact on the financial position or results of operations of the Company. In accordance with NAIC *Annual Statement Instructions*, the Company has made adequate disclosure of its material contingent liabilities where required.

NAIC RATIOS

The NAIC Insurance Regulatory Information System (IRIS) did not designate the Company as requiring regulatory attention based on its Annual Statement filings for any of the three years under examination. In addition, the NAIC Examiner Team did not select for review any of the Annual Statements filed by the Company during the examination period.

The Company's NAIC IRIS Ratio tests were available for all years under review. During the examination period, several IRIS ratios produced "unusual values" as defined by the NAIC Examiner Team in each year under review. The following chart highlights the unusual values in the last year of examination.

<u>Year</u>	<u>Ratio*</u>	<u>Ratio Description</u>	<u>Usual Range of Values Over/Under</u>	<u>Company's Result</u>
2005	3	Change in Net Writings	33 -33	-45.0

Following is a brief description of the underlying circumstances, which produced the “unusual value” in the Company’s IRIS Ratio:

Ratio 3 – Change in Net Writings

This ratio measures the change in net premiums written from one calendar year to the next.

The unusual value was caused by an increase in reinsurance ceded to affiliates applicable to inland marine and medical malpractice claims made business. See the Ceded Reinsurance section of this Report for additional information regarding reinsurance ceded to affiliates. Further, as the Company retains such a small amount of its gross premiums written, any changes in net premiums written will appear significant in terms of percentage.

ACCOUNTS AND RECORDS

Accounting System

All necessary accounting records of the Company are maintained on electronic data processing equipment, which is also shared by the Company’s Delaware insurance affiliates (MRA and AAIC). The general ledger is maintained on a statutory basis with additional accounts used to convert to the accrual basis suitable for Generally Accepted Accounting Principles. The Company’s database was tested as part of Delaware examination procedures.

Independent Accountants

The Company’s financial statements are audited each year by the firm of KPMG, LLP or “CPA”, of New York, NY. The examiners reviewed the audited statutory financial statements for all years under review and noted that the CPA issued an unqualified opinion each year. The

workpapers applicable to the CPA's 2005 audit were obtained and reviewed by the examination and utilized to the extent possible.

Information Systems

INS Services, Inc. reviewed the Company's responses to the Evaluation of Controls in Information Systems Questionnaire (Exhibit C) and performed tests of the systems. INS Services, Inc. concluded the following from their review:

- the Company's responses to Exhibit C present fairly, in all material respects, the aspects of the Company's policies and procedures that may be relevant to their internal control structure,
- the control structure policies and procedures were suitably designed to achieve the control objectives implicit in the questionnaire, if those policies and procedures were complied with, and
- such policies and procedures have been placed in operation as of December 31, 2005.

FINANCIAL STATEMENTS

The following pages contain a statement of assets, liabilities, surplus and other funds as of December 31, 2005, as determined by this examination, along with supporting exhibits as detailed below:

Analysis of Assets, December 31, 2005

Statement of Liabilities, Surplus and Other Funds, December 31, 2005

Statement of Income, December 31, 2005

Capital and Surplus Account, December 31, 2005

Schedule of Examination Adjustments

**Analysis of Assets
As of December 31, 2005**

	<u>Assets</u>	Non- admitted <u>Assets</u>	Net Admitted <u>Assets</u>	<u>Notes</u>
Bonds	\$ 104,378,814		\$ 104,378,814	1
Cash (including cash equivalents and short-term investments	10,821,940		10,821,940	
Receivables for securities	54,478		54,478	
Subtotals, cash and invested assets	\$115,255,232		\$115,255,232	
Investment income due and accrued	940,041		940,041	
Premiums and considerations				
Uncollected premiums in the course of collection	10,587,691	561,883	10,025,808	
Deferred premiums and installments not yet due	883,174		883,174	
Reinsurance				
Amounts recoverable from reinsurers	6,344,168		6,344,168	
Net deferred tax asset	897,834	424,202	473,631	
Aggregate write-ins for other than invested assets				
Imprest Loss Funds/Cash Loss				
Payments in Advance	49,500		49,500	
Total Assets	\$134,957,640	\$986,085	\$133,971,554	

**Statement of Liabilities, Surplus and Other Funds
As of December 31, 2005**

		<u>Notes</u>
Losses	\$10,069,307	2
Loss adjustment expenses	1,533,189	2
Current federal income taxes payable	115,100	
Unearned premiums	5,199,359	
Ceded reinsurance premiums payable	50,476,169	3
Funds held by Company under reinsurance treaties	4,900,537	3
Amounts withheld by Company for the account of others	141,786	
Payable to affiliates	302,668	
Payable for securities	1,994,222	
Aggregate write-ins for liabilities		
Commission Payable	8,742,647	
Additional provision for reinsurance	<u>400,000</u>	
Total Liabilities	\$83,874,984	
Common capital stock	5,000,000	
Surplus notes	20,100,000	
Gross paid in and contributed surplus	10,000,000	
Unassigned funds (surplus)	<u>14,996,570</u>	
Surplus as regards policyholders	\$50,096,570	
Total Liabilities, Surplus and Other Funds	<u>\$133,971,554</u>	

**Underwriting and Investment Exhibit
Statement of Income
As of December 31, 2005**

UNDERWRITING INCOME

Premiums earned	\$10,519,129
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DEDUCTIONS

Losses incurred	\$4,695,447
Loss expenses incurred	1,272,162
Other underwriting expenses incurred	(900,000)
Total underwriting deductions	\$5,067,609
Net underwriting gain or (loss)	\$5,451,520

INVESTMENT INCOME

Net investment income earned	\$4,006,876
Net realized capital gains or (losses)	(187,498)
Net investment gain or (loss)	\$3,819,378

OTHER INCOME

Net gain or (loss) from agents' or premium balances charged off	(\$1,000,000)
Aggregate write-ins for miscellaneous income (expenses)	(1,005,000)
Total other income	(\$2,005,000)
Net income before dividends to policyholders and before federal income taxes	\$7,265,898
Dividends to policyholders	\$7,265,898
Net income after dividends to policyholders but before federal income taxes	\$7,265,898
Federal income taxes incurred	2,544,067
Net income	\$4,721,831

CAPITAL AND SURPLUS ACCOUNT

Surplus as regards policyholders, December 31, 2004	\$46,085,684
Net income	4,721,831
Change in net deferred income tax	(25,291)
Change in non-admitted assets	(685,654)
Change in surplus as regards policyholders for the year	\$4,010,886
Surplus as regards policyholders, December 31, 2005	\$50,096,570

Schedule of Examination Adjustments

<u>Description</u>	<u>Per Examination</u>	<u>Per Company</u>	<u>Surplus Increase (Decrease)</u>
Ceded Reinsurance Premiums Payable	\$50,476,169	\$16,444,552	(\$34,031,617)
Funds Held by Company Under Reinsurance Treaties	4,900,537	38,932,154	34,031,617
Adjusted Liabilities	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>
Net adjustment to policyholders' surplus	<u></u>	<u></u>	<u>\$0</u>

NOTES TO FINANCIAL STATEMENTS

(1) Bonds: \$104,378,814

The above-captioned amount, which is the same as that reported by the Company in its Annual Statement, has been accepted for purposes of this Report of Examination.

An evaluation of the Company's bond portfolio noted that 100.0% of the portfolio consists of bonds with NAIC ratings of 1 or 2. With the exception of bonds held for statutory purposes, investments are primarily held by State Street Bank under a custodial agreement. Refer to the section "External Agreements" of this Report, under the caption "Custodial Agreement" for additional comments regarding this custodial agreement.

A review of corporate records indicated that the Board of Directors has approved the Company's bond investment transactions made during the examination period in accordance with 18 Del.C. §1304.

(2) Losses \$ 10,069,307
Loss Adjustment Expenses \$ 1,533,189

The above-captioned amounts, which are the same as those reported by the Company in its Annual Statement, have been accepted for purposes of this Report of Examination.

The balance reported by the Company was comprised of the following:

Losses

Reported Losses (Case)

Direct	\$ 62,909,700
Reinsurance Assumed	0
Reinsurance Ceded	<u>(61,145,948)</u>
Net Reported Losses	\$ 1,763,752

Incurred But Not Reported (IBNR)

Direct	\$ 99,483,290
Reinsurance Assumed	0
Reinsurance Ceded	<u>(91,177,735)</u>
Net IBNR	<u>\$ 8,305,555</u>

Net Losses Unpaid \$ 10,069,307

Loss Adjustment Expenses (LAE)

Allocated LAE	\$ 123,582
Unallocated LAE	<u>1,357,000</u>
Total LAE	<u>\$ 1,533,189</u>

The examination retained the firm of INS Consultants, Inc. (INS or Consulting Actuary) to review the Company's stated reserves. The Consulting Actuary was provided with the Company's statement of actuarial opinion and an actuarial report as the supporting documentation of the actuarial opinion with loss and loss adjustment expense reserves evaluated as of December 31, 2005. In addition, INS was provided with other reports, schedules, exhibits and relevant information as requested.

The Consulting Actuary's review of loss and ALAE (allocated loss adjustment expenses) reserves consisted of separately analyzing the property and casualty Company's book of business on a gross and net basis. In addition, for unallocated loss adjustment expense (ULAE- also known as "Adjusting and Other"), the Consulting Actuary reviewed the methodology employed by the Company's actuaries. INS accepted the methodology and factor selections utilized by the Company's actuaries.

In conjunction with the actuarial review, the examination team was tasked with validating the loss data used by the Company. Based on the examination team's review, it was ascertained that the data was accurate and complete.

(3) <u>Funds Held By Company Under Reinsurance Treaties</u>	<u>\$4,900,537</u>
(3) <u>Ceded Reinsurance Premiums Payable</u>	<u>\$50,476,169</u>

The above-captioned amounts are different amounts than what were reported by the Company in its Annual Statement for each item. Funds Held By Company Under Reinsurance Treaties was overstated by \$34,031,617, while Ceded Reinsurance Premiums Payable was understated by the same amount. The differences are the result of a reclassification between the two accounts. The reclassification, which is explained below, did not result in a net change to policyholders' surplus.

At year end 2005, the Company reported the amount of \$34,031,617 for Funds Held By Company Under Reinsurance Treaties for a liability due to MRA. A review of the account indicated that the \$34,031,617 was in fact deferred ceded premiums payable. The NAIC Annual Statement instructions state that deferred ceded reinsurance premiums payable should be reported in the liability line item: Ceded Reinsurance Premiums Payable. As such;

It is recommended that the Company comply with the NAIC Annual Statement instructions and report all deferred ceded premiums payable in the annual statement liability line item Ceded Reinsurance Premiums Payable.

COMPLIANCE WITH PRIOR REPORT RECOMMENDATIONS

A review was performed of appropriate balance sheet and forepart files to verify corrective action had been taken with regards to prior examination report comments and recommendations. Based on that review, it has been determined that the Company has complied with the prior examination report comments and recommendations.

SUMMARY OF RECOMMENDATIONS

1. It is recommended that the Company comply with the NAIC Annual Statement instructions and report all deferred ceded premiums payable in the annual statement liability line item: Ceded Reinsurance Premiums Payable (Notes to Financial Statements). (p.25)

SUMMARY COMMENTS

1. Territory and Plan of Operation: Corporate Restructuring and Change in Underwriting Approach

During 2002 the US operations of Munich Re (MRG-US) underwent a corporate restructuring. Separate Strategic Business Units (SBU's) were created for the purpose of segregating its major underwriting operations. The five main SBU's are Direct Treaty, Direct Facultative, Direct Broker, Risk Partners and Healthcare. The business underwritten by PESLIC is produced by the Risk Partners SBU. NOTE: MRG-US consists of PESLIC and MRA and AAIC.

In addition, MRG-US has become more conservative during the examination period in terms of the business being solicited and underwritten. The corporate philosophy is that risks

underwritten by MRG-US should have risk adequate premium, meaning that the appropriate premium for a given risk does not fluctuate simply because the reinsurance market is hard or soft. The Company appears to have applied this underwriting discipline over the past few years and it is expected to be part of their plan of operation in the years to come. MRG-US is willing to restrain its underwriting when the market becomes soft and if premiums are significantly lower than what the Company has determined are adequate for the risks being underwritten or assumed. (p.11)

2. Ceded Reinsurance: Significant Reinsurance Protection

PESLIC maintains a significant amount of ceded reinsurance coverage, retaining only \$7,339,685 or 5.7% of gross premiums written in 2005. Significant reinsurance coverage is provided from both affiliates and non-affiliates. Specifically with regards to affiliated coverage MRA provides PESLIC with excess of loss, net aggregate quota share and accident year stop loss coverages leaving PESLIC with minimal net retained risk. (p.13)

CONCLUSION

The following schedule shows the results of this examination and the results of the prior examination with changes between the examination periods:

<u>Description</u>	<u>December 31 2002</u>	<u>December 31, 2005</u>	<u>Increase</u>
Assets	\$39,153,805	\$133,971,554	\$94,817,749
Liabilities	\$8,576,804	\$83,874,984	\$75,298,180
Surplus as Regards Policyholders'	\$30,577,001	\$50,096,570	\$19,519,569

In addition to the undersigned, Albert Piccoli, CFE, Joe Rome, CFE, Paul Ellis, CPA, CFE, John P. White, Jim Russo, CFE, and Legh Cathey, CFE participated in the examination. James J. Blair, Jr., CPA, CFE served as the examination supervisor. The assistance of Gene Thompson, ACAS, MAAA of the actuarial consulting firm, INS Consultants, Inc. is acknowledged along with the information systems consulting firm of INS Services, Inc.

Respectfully submitted,



Gregg S. Bealuk, CFE
Examiner-In-Charge
State of Delaware
Northeastern Zone, NAIC